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Role of Federal Funding in Leveraging Additional Financing

For Water Projects in the United States

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The U.S. population increased by 13.2% between 1990-2000, with the West and South regions leading the nation in terms of growth at 19.7% and 17.3%, respectively.⁽¹⁾ Future projections indicate this trend will continue through 2025, albeit at a slightly reduced rate of growth overall.⁽²⁾ To meet the consumptive water needs of this increase in population, additional water supply, treatment, and distribution infrastructure will be required. Historically, the federal government has played an important role in financing water projects through direct and indirect funding measures: directly, as in funding the construction of dams through the Bureau of Reclamation and the Army Corps of Engineers, and indirectly, as in the funding of water and wastewater infrastructure through Environmental Protection Agency (EPA) grants to the State Revolving Fund (SRF) programs. While future federal funding will be driven by policy decisions of the President and the Congress, the method of how those funds are dispersed will determine the leveraging capabilities of the appropriations.

Direct grant funding is arguably the most cost-effective mechanism for disbursing federal funds on a project basis, but no opportunity exists for leveraging of those dollars. Because direct funding is targeted to specific projects, administrative costs potentially can be minimized thereby providing more actual dollars for a project than if monies are appropriated as part of a federal or state program. This ultimately would reduce the cost of a project. However, the primary limitation to direct grant funding from a fiscal perspective is that a grant by nature is a one-time source of funds for one specific purpose. This means that funding for other projects would require additional grants. So simply providing direct grants for a specific project, while there may be political, environmental, or economic justification for such funding, typically limits the benefits of the grant to the immediate recipient and fails to leverage those monies for additional needs.

A method of maximizing federal dollars is to provide 'seed capital' for investment in an interest-bearing account. Additional monies could then be generated and utilized indefinitely or over a set period of time. In the case of a defined spending timeline, the required appropriation to fund a project or set of projects would be reduced based upon

the rate of return of the capital investment and the timeframe over which the fund was depleted, essentially functioning in the same manner as an individual retirement account. For purposes of funding water projects, this would mean that grant funds would generate interest earnings, with the interest earnings and a portion of the grant dollars being used as direct grants for projects. The leveraged amount in this case would equal the total interest generated over the lifetime of the draws.

To maximize federal leveraging further and ensure perpetuity of available funding, the 'seed capital' should remain intact and continually be invested (i.e. loaned). For practical purposes, the appropriation could be utilized as a zero-percent loan to entities. This particular method of funding projects enhances the

leveraging capacity of the federal funds over an extended period of time in that repayment of principal would be available for additional projects. At the same time, borrowers receive a direct benefit in the form of an interest subsidy. However, because no interest earnings would be generated, the amount available for future projects would be limited both as to the initial investment and the timeframe of the repayment of the loan or loans.

To enhance the perpetuity of the appropriations and provide the most in terms of leveraging the 'seed capital', the principal should be reinvested in loans to prospective entities which are repaid with interest. The Clean Water and Drinking Water SRFs are perhaps the best example of this type of funding program. Federal grants, along with state match monies, are deposited into the respective SRFs. Monies within the SRF fund are then loaned to recipients at rates below that which the applicants could receive on their own in the open market, but the fund continually expands as principal and interest repayments are received and then reloaned to other entities.

To meet the vast water and wastewater demands across the nation, many SRFs also issue leverage bonds in the open market which provide additional sources of revenue for funding water and wastewater infrastructure needs beyond that which could be accommodated from available program funds. These leverage bonds are overcollateralized by federal grants and state matching monies, meaning that pledged resources exceed projected debt service liabilities, and this overcollateralization typically allows the bonds to achieve Fitch's highest credit rating. By achieving such superior ratings, SRF borrowing costs are typically less than what an individual borrower would achieve if such borrower were to access the open market on their own. Because of this leveraging, use of federal funds is enhanced as opposed to funding loan projects on an individual basis.

Indicative of the success of the SRF programs to leverage federal dollars for water and wastewater infrastructure funding is the ratio of federal capitalization grants contributed to the amount of actual assistance provided. Moreover, for those states that have issued leverage bonds, the ratio of assistance provided is greater than states that have yet to do so. As of June 30, 2002, the EPA reports that the total amount of Clean Water SRF assistance as a percentage of federal capitalization grants for states issuing leverage bonds was 228%, compared to 144% for states which have not leveraged.⁽³⁾ Likewise, for the same period Drinking Water SRF assistance as a percentage of federal capitalization grants for states issuing leverage bonds was 222% compared to 90% for states which have not leveraged.⁽⁴⁾ While the SRF programs are perhaps the best example of leveraging federal dollars, the concept of utilizing federal monies to provide 'seed capital' for a perpetual loan fund and issuing leverage bonds to increase the immediate source of funding availability has the potential to maximize federal funding for many types of public projects.

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